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Li, Pingli, Tang, Guliang, Okano, Hiroshi and Gao, Chen (2011) Management controls in automotive international joint ventures involving Chinese parent companies. Project Report. Chartered Institute of Management Accountants. . [Monograph]

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# Management controls in automotive international joint ventures involving Chinese parent companies

Research executive summary series

Volume 7 | Issue 9

### Key findings:

- Flexibility in international joint ventures (IJVs) is important and a shared but split control style is recommended.
- Chinese partners used to have learning as their main objective in an IJV but this has been replaced by profit, growth and market share.
- The most significant shifts in control between partners involve human resource management and research and development.
- When foreign partners insist on adherence to their own management philosophy, culture clashes occur.
- Negotiation is a part of daily life in the IJVs, and it occurs at both executive and managerial levels, depending upon the significance of the item.

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## Acknowledgements

Researchers would like to thank CIMA's general charitable trust for funding this project. We are also grateful to Professor Chris Chapman, Professor Franz Waldenberger, Professor Tae Sik Ahn and the interviewees involved for their kind support during the research process.

## Overview and objectives

This project investigated the management controls exerted by overseas and local parents in four automotive international joint ventures (IJVs) in China. A shared but split management style was identified, which supplements the previous studies on IJVs management. The study also found evidence on the dynamics of management controls and the drivers behind change.

Over time, IJVs have become common in a wide range of industries due to rapid technological changes and increased emphasis on globalisation strategies. The emergence of China as the 'factory to the world' and its rapidly growing domestic market are attractive to investors. For example, in 2009 China sold 13.5 million vehicles and became the largest car market overtaking the United States who sold 10.4 million in 2009. Established 'old world' firms cannot ignore these markets if they want to maintain pre-eminence in mass markets.

Cultural pressures, government imposed controls and the costs of setting up new operations and far away markets mean that partnerships with local firms are often the most sensible, or only form of business development. This often occurs if the overseas firm wants to be an integral part of the local economy and not simply an importer. Consequently, China has become the world's largest recipient of foreign direct investment today, and IJVs between overseas and Chinese companies become one of the predominant modes of entry into China. From 1982 to 2004, China experienced an average annual growth rate of 24% in foreign investment and almost 32% in equity IJVs. In the automotive industry, IJV is the only available mode because the Chinese government does not allow wholly foreign owned enterprises and requires that Chinese partners hold at least 50% equity in IJVs.

While there are more opportunities for multi-national enterprises to realise their objectives in China, the control of IJVs is very challenging. Previous studies suggest difficulties in managing IJVs involving Chinese partners and management controls have been identified as one of the factors that influence the performance of IJVs (e.g. Geringer and Hebert, 1989; Chalos and O'Connor, 2005). In order to effectively exert management controls, it is important to understand how such controls have been applied in practice.

This study adopts a bargaining power model to examine what and how management controls have been exerted by overseas and local parents, and how these have been shaped by the relative bargaining power of parents. The bargaining power

model has been used to explain how a parent can use its resources and capabilities to gain control of its IJV to ensure the best possible return from the investment on the IJV. It also explains how to protect its strategic resources – like intellectual property – against industrial espionage (Yan and Gray, 1994). The previous studies of applying this model focus on the IJV formation stage and take the perspective that management controls are affected and determined at an IJV formation stage. We know little about how managers from different parents co-operate and compete simultaneously in the control process.

Aiming to close some of the above research gaps, the present study conducted four case studies and attempted to address the following two research questions:

1. What management control mechanisms have been exerted in the case companies, and how?
2. How do management controls evolve and what are the drivers behind change?

## Findings

The general background of these companies can be outlined as below:

- All are automotive IJVs in China, involving one European; one Japanese; and one Korean overseas company.
- The Chinese companies involved are state-owned and located in four different regions.
- All have 50/50 shareholdings between overseas and local partners.
- All could be regarded as successful, based on two criteria:
  - certain operation periods (six to eight years) and survival to date.
  - reported executive satisfaction with the achievement of objectives.

## The control mechanisms adopted by both parents

There are a variety of control mechanisms a partner may adopt in the control of its IJV. From our observation, the main mechanisms used by the overseas partners are:

- staffing
- adopting similar production and management systems
- mentoring and training.

Those used by the local partners are:

- staffing
- budgeting.

Although the overseas partners participated in budgeting, they used it mainly as a tool for planning, rather than as a control mechanism.

## Shared but split control style

The study identified the control model of the IJVs as 'shared, but split', as depicted in Figure 1.

### Control access to the entire range of activities: share control

Based on 50/50 shareholdings, the overseas and local partners hold the same seats on the board of directors. All decisions in the case companies are made by consensus and no partner can be outvoted. This governance structure allows both parents to share control over the entire range of activities.

This finding is consistent with previous studies on the control focus from overseas partners, but inconsistent with the local side. The Chinese partners used to focus their control only on specific areas and did not have motivation for overall control, as identified by prior studies. In our case companies, the Chinese partners have shown strong desire for overall control and have actually obtained the control access to the entire range of activities. From our observation, this change might be the result of their shifted objectives. Chinese companies used to have learning as their main objective in IJVs, but our case studies show their three most important objectives to be profit, growth and market share.

## Tight control over specific areas: split control

A partner's control can be regarded as tight when there exists a high degree of certainty that decisions will be made as that partner wishes. While the overseas and local parents have the same control access to the entire range of activities, it does not mean that they have the equal control tightness in all areas. Partner control tightness in particular areas is linked to their resource contributions, as observed from the case studies.

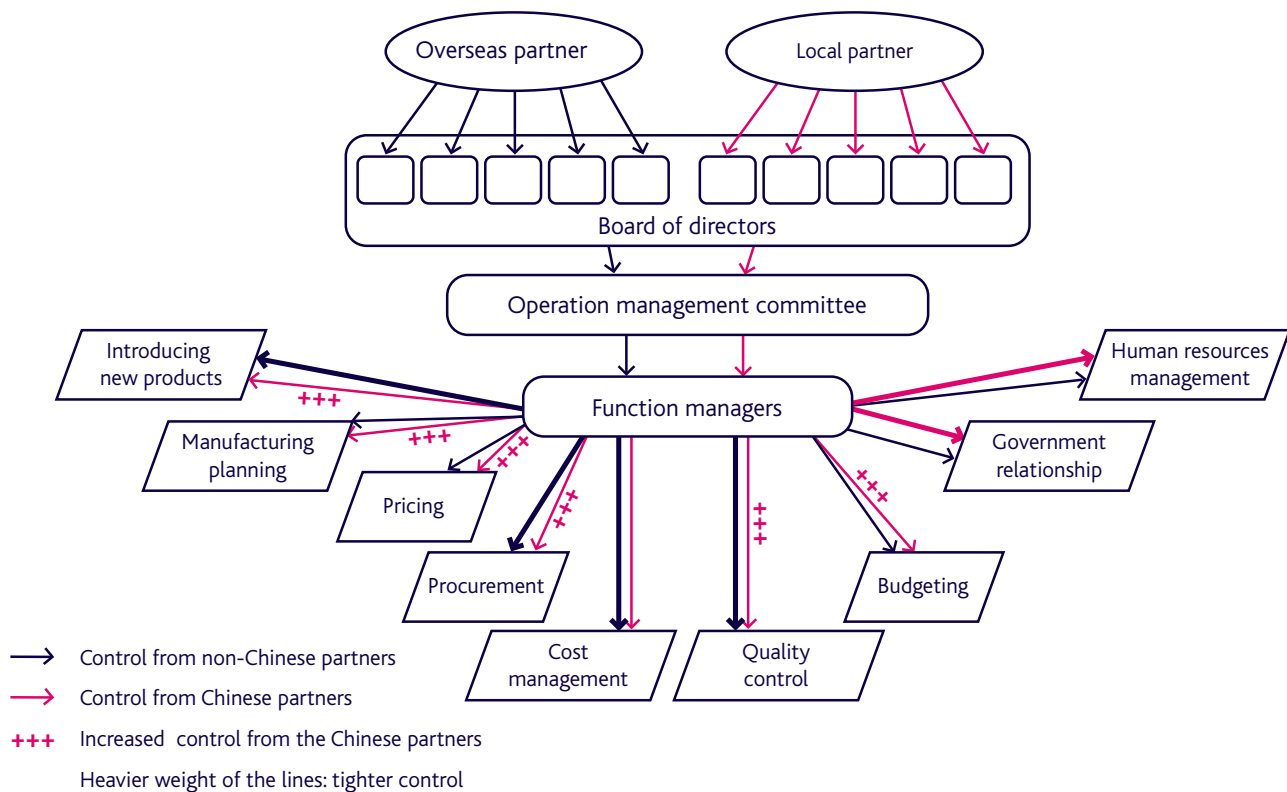
The resources contributed by both parents – apart from financial investment – are not even. From our investigation, the most important resources contributed by the overseas parents are:

- manufacturing techniques
- operation management systems
- supplier networks
- distribution of products
- product brands.

Contributions of the local parents are:

- local market knowledge
- government resource input and policy support
- expertise in local human resources management .

**Figure 1.** Shared but split management style and its dynamics



1 Previous studies on the control of IJVs identified four control styles as 'shared, dominant, independent, and split'. For detailed explanation of these styles, refer to Geringer and Hebert, 1989; Killing, 1983.



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A shared control style allows both parents to exert overall control, however the same extent of control tightness across all areas from two parents might result in inefficiency and increased managerial difficulty. Rationally, both parents choose 'shared but split control' – they only exert tight control over the areas in which they possess technology and knowledge. In the case study companies, the overseas partners exert tighter control over introducing new products, procurement, cost management and quality control. The local partners exerted tighter control over the areas of human resource management, government relationship, and they share a balanced control over manufacturing planning, pricing, and budgeting, as shown in Figure 1.

### Benefits of adopting a shared but split control model

While the importance of local markets and government policies in certain industries award local companies with greater bargaining power, shared management would increasingly be preferred by local parents. This is contrary to the findings of previous studies. Overseas company dominant management might also be undesirable for foreign parents because it potentially hampers IJVs benefiting from the knowledge and management expertise of local parents. A 'shared but split' management style reflects the strategic positions of both parents, provides them with control access to the entire range of activities, and offers them the opportunities to play out their strengths that are important for the success of an IJV.

### The dynamics

Although there is no evidence of significant changes in the corporate governance structure in the case companies, the study found that control tightness in some areas has shifted between the partners during the operation of the IJVs. The most significant changes are in the areas of human resource management (HRM) and research and development (R&D).

### Increased control tightness on HRM from the local parents

Because of their strength in technology and management, the overseas partners initially pursued tight control in all areas, including HRM. This caused various problems in the management of those IJVs. For example, a Japanese IJV did not apply punishment to workers at the beginning of its operation based on its culture of loyalty through 'life-long employment'. This did not prove a good fit with the Chinese culture, and this IJV has changed to a policy of combining appraisal and punishment, which is commonly applied in local companies.

Similar changes occurred in all the case companies, although to a differing extent.

### Increased local parent influence on design and marketing of new products

When overseas parents insist on adhering to their own management philosophy, they encounter a culture clash. For example, an overseas parent was not completely satisfied with their performance in the Chinese market in terms of market share. They identified the main reason as their marketing strategy not fitting well into the Chinese culture. 'We should put more efforts on understanding China, understanding how local people think,' reflects an overseas Financial Manager in this IJV. As a consequence of this reflection, this IJV established an R&D department in 2008.

The two IJVs we studied recently established their R&D departments, and a third has announced a plan to establish a joint R&D institute in late 2011. Overall, the opinions of local parents and managers on introducing new models are taken more seriously, and decisions are made more locally, as evidenced in all case IJVs.

In general, we observed increased influence from the local partners over the areas of introducing new products, manufacturing planning, pricing, quality control, budgeting, and their dominant control over HRM in all case IJVs, as shown in Figure 1. The extent of these changes varied across the firms.

The acceptance of the shifted control tightness from both overseas and local parents provides empirical evidence that IJVs need to reconfigure over time in response to changes in the partners' relative bargaining power to ensure stability and overall performance (e.g. Yan & Gray, 1992). The shared and split control style fitted well with this dynamic environment.

### The factors promoting the changes

The drivers behind the control dynamics are identified as below:

- The acknowledgement of cultural differences from the overseas companies.
- The increased importance of the Chinese market in the globalised world.
- The influence of local government, as further discussed below.

### The role of local government

Because of the economic significance of the automotive industry and that local partners were state-owned, local government plays a significant role in China at the IJV formation and operation stages. The present study reveals that while the involvement of local government brings vital resources and support to an IJV, it also adds uncertainty. This is one of the factors contributing to the control dynamics.

Our study identified the following ways in which local

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government affects IJVs.

- At the formation stage, the resources and support provided by local government are an important consideration for the overseas partners, as observed in all case companies.
- Local government's political needs may affect management control at the formation and operation stage.
  - Overseas partners may win favourable deals by taking advantage of the urgent political needs of a local government. Such needs may include having more IJVs in a certain area, improving the performance of state-owned firms, and rapidly increasing industry size.
  - Overseas partners may have to compromise later. For example, local government may add extra conditions to an approval request relating to certain activities during the operation of an IJV. An important motivator for one of the case companies to set up an R&D department was a precondition the local government set when the IJV requested its approval for building a new factory.

### Bargaining in control process

Bargaining during the operation process is observed in all four case companies, although the level of intensity differs. This brings the elements of support and challenge from two parents into the relationship between the managers. 'We are in the meetings most of the time' – all managers we interviewed made this comment on their experience. Furthermore, they ranked the improved negotiating ability as their most important work-based learning outcome.

The case studies reveal both partners take profit, growth and market share as their most important objectives. However, they prioritise differently, especially in the first few years – the overseas partners' primary objective is local market share, while the Chinese partners do not want to sacrifice profit for growth. This gap is caused largely by the un-equal number of profit sources from and un-even control over the profitability of IJVs between partners.

First, the profit pool available to the overseas partner of an IJV may be larger than the IJV itself. For a local partner, distributed profit is the main financial income from its IJV. In comparison, overseas partners have many other ways to benefit financially from the IJVs because of their contribution of technology and supplier networks. These profit sources include equipment sales, technology transfer fees, related transactions with suppliers, and other inter-organisational transactions. In one case company, the local managers once analysed and identified 18-20 sources from which the overseas partner could profit from this joint venture, in addition to the distributed profit. Moreover, for an overseas

partner, the establishment of an IJV also enhanced its business development in other areas in China.

Second, the tighter control on transfer pricing and new product introduction from overseas partners has further increased the extent of their control over IJV profitability. While the parents share the profit 50/50 – as determined by the equity shareholding – the total amount of annual profit is significantly affected by the negotiation of transfer prices and product portfolio decisions. When the principles of setting transfer prices have been negotiated in the formation stage of an IJV and stated in the contract, the specific figures for each year vary depending on the items for transfer.

Circumstances make negotiation a part of daily life in the IJVs:

- less profitability-focus due to the number of profit sources with stronger control over IJV profitability for overseas partners
- stronger desire for profit but a weaker position in profit control for local partners.

Negotiation occurs at both executive and managerial levels, depending upon the significance of the item.

### Implications for investors and managers

#### The shared but split control style: model with flexibility and fitting well into dynamic environments

Being successful in China has never been more important to multi-national enterprises because of the enormous size and the developing speed of Chinese markets. While this strong market provides more opportunities for overseas companies, it also awards local companies stronger bargaining power. Together with shifting objectives from learning to profitability and growth, we should not be surprised by local companies' desire to be actively involved in the control of the entire range of activities within IJVs. Keeping the flexibility in control would enhance the cooperation between overseas and local parents, reduce the managing difficulty, and eventually bringing mutual benefits. The shared but split control style we identified from the case studies is an example of such flexible models.

#### Be aware of the different roles that may be played by local government

The interference of local government in China occurs at the formation and operation stages, and could bring benefit or challenge into IJVs. It is important for the investors to be aware of the nature of the interference and be prepared to deal with it, either taking advantage or compromising.

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## Prepare expatriates with negotiating skills

For the managers in an IJV, negotiation is a part of their daily life. Parent companies and managers should realise that negotiation exists not only at the formation stage and board level, but also at the operation stage and the executive and managerial levels. Preparing managers with good negotiating skills is important not just for the success of any IJV, and also for the well-being of those managers involved.

## Conclusion

The present study provided the first observation on evolutionary changes in the extent of controls exerted by parents in their IJVs. The factors promoting changes were identified as culture clash, rapid market changes and the roles played by local government. The influences of these multiple forces in the control process increase the difficulty in managing IJVs in China. Our study recognised the importance of keeping flexibility in managing IJVs in China and identified such a flexible model as a shared but split control style. Our research found that managers clearly have a role to play in the effectiveness of controls in IJVs. Management controls have not just been determined at the formation stage of an IJV, but also shaped by the negotiation and changing bargaining power during the operation.

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**ISSN 1744-702X (print)**

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